CIA/OER/S-06633-74 EFFECT OF ECONOM PROB ON NEGOTIATING STANCE OF ISRAEL, EGYPT, & SYRIA MAR 74 SECRET/NFD 01 OF 01

SECRET
NO FOREIGN DISSEM

CIA Control No. 9371

CIA/OER/S-06633-74 4 March 1974

MEMORANDUM

Effect of Economic Problems on the Negotiating Stance of Israel, Egypt, and Syria

Summary

We do not believe that Israel, Egypt, and Syria will encounter economic problems great enough to pressure them into making major concessions in the coming peace negotiations. Each country has the assurance of foreign financial backing that would see it through short run domestic economic constraints.

- Israel will be able to expand defense output, sustain basic civilian needs, cope with high inflation, and improve its foreign reserves position with the receipt of $2.2 billion of projected aid from the US.

- Egypt can maintain and possibly increase output beyond the 1972 levels on the basis of aid already received and that pledged by other Arab states.

- Syria's largely self-sufficient economy can cope with existing economic problems, including the reconstruction of war damage, with the help of funds from other Arabs.

The economic incentives for an early peace settlement are stronger for the Arabs than for the Israelis, although each would benefit in the long run. Egypt would gain some $300 million annually in oil revenues with the return of Sinai. Syria could resettle about 170,000 refugees, reduce unemployment, and increase national output. On the other hand, the loss to Israel of the Sinai oil and of its territorial defenses in the East and the West would greatly increase oil import costs and defense expenditures.

SECRET
NO FOREIGN DISSEM

13

Over the longer run, Israel also would derive economic benefits from a peace settlement. Resources could be shifted from defense to the civilian economy and trade benefits would be derived from improved relations with the Arab states. Peace also would restore a climate for increased foreign investment in all three countries.

Introduction

Israel, Syria, and Egypt are under varying degrees of economic pressure to reach accommodation of their differences and to move to a final peace settlement. However, US aid for Israel and Arab and Soviet aid for Egypt and Syria have minimized the impact of economic problems on peace negotiations. The following describes briefly each country's economic position and its relationship to a negotiated peace.

Israel

Israel's principal economic problems since the October war have stemmed from the mobilization of reservists and the diversion of resources from development to defense. Manpower shortages caused by mobilization and the loss of Arab workers continue to affect output but are not as severe as in November and December 1973. With disengagement at Suez, Israel now has about 100,000 reservists mobilized -- half the wartime level -- and more than half of the Arab workers have returned. The downturn in output that resulted from the reduced labor force has been overcome partly by increased labor productivity. Even if Israel were to demobilize rapidly, however, labor constraints are likely to be a problem for the Israelis for some time to come.

The burden of large defense spending during 1974 and 1975 will hang over the economy regardless of what happens in the peace negotiations. Defense expenditures in 1974 are tentatively set at $4 billion, more than half of the total budget and nearly half of projected GNP. By contrast, Israel spent $1.6 billion, or under 20% of GNP, on defense last year. Military imports in 1974 of $2 billion will be four times the pre-war level. Projected expenditures of $1.5 billion on imports and local defense production in 1975 probably will remain high even if a peace settlement is concluded. The

Israelis will depend even more on an expanded IDF when defense barriers afforded now by the occupied territories are no longer available for defense.

US aid is covering the foreign exchange costs of maintaining an enlarged defense establishment. The domestic economy has undergone some belt tightening and cuts have been made in output of civilian goods. The government has reduced civilian demand by cutting the development budget, collecting new taxes, and selectively lowering subsidies -- or raising prices. The extent to which Israel has to cut civilian demand will depend on the levels of US aid and on the amount of funds collected from World Jewry.

The Israelis have indicated a willingness to negotiate the return of territories captured in the 1967 war. The loss of the economically important Sinai oil fields probably would be tied to assurances from the US of oil supplies or an oil purchase agreement with the Egyptians. The Israelis would like also to have assurances of continued access to Arab workers from the territories. Arabs and Israelis both stand to gain from this transfer of labor.

In the long run, Israel stands to gain from a peace settlement the chance to reduce defense costs, to increase trade with neighboring Arab countries and, to a lesser extent, increased incentives for foreign investors.

Egypt

So long as Arab subsidies of about $250 million annually are maintained, Cairo can pursue its diplomatic goals for a year or more unhampered by serious economic problems. Egypt is now experiencing considerably less economic hardship than during the immediate pre-war years when a severe economic downturn was in progress. Thanks mainly to extraordinary aid receipts during the fourth quarter of 1973, Egypt is in a position to maintain 1972 output levels for about two years and may even be able to achieve a modest amount of economic growth.

During the course of negotiations Egypt will be motivated strongly to regain lost assets on Sinai, and

to secure at least the illusion of permanent peace for economic as well as political reasons. At current oil prices, annual proceeds from Sinai oil fields would total more than $300 million. This sum, plus Suez Canal revenues, SUMED pipeline revenues, and Khartoum aid would close Egypt's payments gap and permit a 6-7% annual economic growth. If the risk of war is reduced by a settlement, private investment and loans from multi-lateral Arab lending agencies could replace Khartoum aid, cancelling much of the uncertainty and almost all of the political log-rolling formerly associated with Egypt's heavy dependence on bi-lateral aid. On economic grounds radical Arab fears that Cairo is inclined to sacrifice Palestinian interests for a unilateral settlement are not completely unfounded.

Even with disengagement accomplished, Egypt is still too dependent on external economic and military aid to freely pursue its own inclinations. So long as any threat of war exists, tolerable relations must be maintained with the only reliable source of arms, the Soviet Union. Cairo will be even more obligated to the affluent Arab states on whom they depend both for arms purchases and for balance of payments support. Lack of agreement among Arab states on some issues allows Egypt considerable room for both political and financial maneuvering. On other issues, such as recognition of the Palestinian state, on which there is greater unanimity, Egypt could be forced by economic necessity to yield to the prevailing Arab view.

Over the longer term, mounting economic problems could reduce Egypt's latitude and greatly harden its point of view. If accumulated assets are expended before peace is assured, greater dependence on bilateral aid could increase Egypt's vulnerability to Arab pressures. Should mounting tensions in the area discourage private investment or prolonged stalemate discourage Arab aid, as in the previous inter-war period, Egypt's economic prospects in 18 to 24 months could worsen rapidly.

Syria

Syria's posture toward negotiations with Israel is largely unaffected by internal economic developments. Damascus wants to avoid repetition of the destructive

October conflict that resulted in losses roughly equal to one year's national output. But given the desire for peace, the Syrian leadership is not under any economic pressure to arrive at a settlement which would dilute the objectives for which it went to war.

One of its prime objectives is return of all captured territories, including the Golan Heights and the city of Qunaytirah. Although primarily of political importance, the territorial reacquisition would yield some economic dividends to Syria. The resettlement of a reported 170,000 refugees from the area would reduce unemployment and contribute to increased domestic output and income.

The government currently is restoring the war damage inflicted on the electric power and petroleum sectors. It is also pushing ahead development programs for road and rail construction and the important Soviet-aided Euphrates Dam and irrigation project. Continued mobilization of Syrian armed forces places little strain on the labor force since high unemployment prevails. Inflation associated with shortages of food and other goods exists, but, as during the war, Syria's populace appears willing to share such hardships as part of the struggle against Israel.

With abundant Arab funds at its disposal and continued large support from the USSR and Eastern Europe, Syria is in a good position to cope with its economic difficulties.

Syria will not be pressured by threats of cutting off aid. The aid donors have mixed attitudes regarding negotiations with Israel and, even an obdurate stance by Syria, is unlikely to find all donors allied in withholding aid. Political rather than economic pressure probably would be relied upon by the individual countries. Thus, for example, if the Soviets withdrew economic and military aid -- an unlikely scenario given Moscow's desire for a favorable image with the Arabs --, Syria probably would receive substantial aid inflows from other quarters, notably Libya and Iraq. The Saudis, who reportedly have offered some $1 billion in aid, conceivably also would support a strong Syrian stand on negotiations particularly one calling for return of East Jerusalem.

ISRAEL: ECONOMIC IMPACT OF THE WAR

Conclusions

Israel has no short-term need for additional foreign financial aid beyond credits to finance military imports. The balance-of-payments surplus for 1973 will almost certainly increase as a result of the war because foreign remittances will rise more than the current account deficit. In the longer term the need for aid will depend on the amount and terms of arms purchases. Aid needs for the civilian economy will be negligible unless mobilization continues for many months. Even in this event, the Israeli's would pay much of the current cost of military readiness by reducing domestic investment and consumption.

The Economy Before the War

Israel's economy was in a strong position before the war, with growth of real GNP projected at about 8% for 1973, after nearly doubling during 1969-72. Foreign exchange reserves had reached US $1.5 billion in September 1973, about $300 million above the level at the end of 1972 and equal to more than one-third of annual imports of goods and services. Inflation, which had reached an annual rate of 20%, was the principal economic problem and was caused by high domestic demand, nearly full utilization of productive capacity, and rising import prices.

The outlook for the balance of payments remained good in 1973, although it was unfavorably affected by inflation. After marked improvement in 1971-72, the current account deficit was increasing in 1973 as a result of booming imports, while capital account earnings were running below the previous year. Nevertheless, Israel, thanks to large borrowing, continued to accumulate foreign exchange reserves.

The longer term trends in the Israeli balance of payments were healthy. Exports were increasing faster than imports, and the current account deficit was expected to decline after 1974. Although

015319

Date Impossible to Determine

Israel's foreign debt had risen sharply during the years since 1969 and at the end of 1972 stood at $4.2 billion, the largest per capita debt in the world, servicing of the debt was not creating any difficulties. The ratio of debt service to export earnings was declining, and debt service payments -- about $600 million in 1972 -- were more than offset by the inflow of unilateral transfers. With bond sales also likely to remain at high levels, Israel's prospective balance-of-payments surplus in 1974 and 1975 seems likely to exceed the level of US aid.

	Million US $			
		Projected		
	1972	1973	1974	1975
Goods and services	-1,103	-1,550	-1,350	-1,150
Unilateral transfers	1,054	865	1,000	1,050
Capital account	331	288	500	450
US assistance	440	547	450	350
Increase in reserves	722	150	600	700

Economic Impact of the War

The Israeli economy has been disrupted, but not severely, by the war. There has been virtually no war damage. The callup of reservists, which together with the loss of Arab labor from the occupied territories, cut the civilian labor force by about 25%, and the sequestering of trucks by the military caused some economic disruption. Adjustments have since been made, however, including a return of critical workers to their jobs and a substantial increase of the number of women and teenagers in the labor force. Although some services, such as tourism and the construction industry, have been hit hard, other industries and agriculture appear to be producing near pre-war levels. There has been no rationing of consumer goods and services.

Israeli officials have estimated the value of lost production at $14 million a day, or nearly

$100 million a week. This would mean more than $5 billion at an annual rate, or two-thirds of the GNP of $8 billion. Beyond the first few days of the war, this rate of loss is obviously greatly exaggerated. Although aggregate figures are not available, a more reasonable estimate would be a drop of 20% in civilian production, or less than $30 million a week. As indicated below, the increase in domestic military expenditures, excluding military imports, is probably running at an annual rate of some $1 billion, or some 12% of GNP. The civilian labor force probably has not been cut more than 15%, representing much less than full mobilization. A 20% drop in GNP appears to make ample allowance not only for diversion of resources to military use but also for some continued disruption of economic activity.

The supply of trucks probably is the most troublesome bottleneck in the Israeli economy. With many civilian trucks being used by the army, the civilian economy is short of convenient transportation and the Israeli government is trying to import trucks on a priority basis. The supply of petroleum constitutes a potential problem. Closure of the Bab al Mandab Strait has stopped petroleum deliveries to Eilat from Iran. During the fighting, petroleum tankers also stayed away from Israel's Mediterranean ports. Israel's petroleum stocks, however, amounted to more than 16 weeks of supply at the beginning of the war, and if major fighting does not resume, Israel can import sufficient petroleum via the Mediterranean.

Dry cargo ships are entering and leaving Israeli ports, although there was a slowdown during the fighting. There appear to be no serious actual or potential shortages of imported goods.

The government's Ministerial Economic Committee has assigned priorities for keeping the economy as close to normal as possible during the war. Priorities include preserving export markets, completing housing for high priority groups (immigrants from the USSR who have continued arriving during the war), finding new sources of financing, and returning key workers from military service. To ease the transportation bottleneck, the government has allocated 1,400 heavy-duty trucks for civilian

distribution and is seeking to import 2,500 trucks on a priority basis. The Bank of Israel has agreed to an extension of credit to ease short-term liquidity problems.

Cost of the War

Israeli statements on the cost of the war have varied considerably; the most often quoted figures -- $250 million a day and $2 billion in the first week of the war -- seem exaggerated. Israeli officials apparently lumped together the direct and indirect military costs of the war and the economic costs, including the value of output lost and losses of foreign exchange earnings. The major costs will be for the replacement of military equipment and materiel, the impact of which will be spread over a number of years.

Our preliminary estimates place the value of Israel's losses of major military equipment at a minimum of about $325 million. Expenditures of military supplies and supporting equipment would add considerably to these costs. Before the war, Israel had contracted to purchase from the United States about $500 million worth of military equipment, including 48 F-4 and 42 A-4 jet aircraft valued at about $300 million, to be delivered out of FY 1974 Foreign Military Sales funds. Since the war began, the United States has approved for sales to Israel $825 million in military supplies of which $500 million to $600 million has been shipped.

Israeli officials have reportedly put a price tag of between $2.5 billion and $3.0 billion on the replacement of its 1973 losses and the purchase over the next three years of additional armaments needed to maintain military parity with the Arabs. Israel would like to double its air force to 1,000 aircraft and raise its tank inventory to 4,000 vehicles. Beyond this, the Israelis plan to increase their domestic military production. They have tentatively set a goal of supplying one-half their military equipment needs from domestic defense industries, compared with about 30% now coming from domestic industries.

Before the October war the 1973 defense budget was estimated to be $1.6 billion, of which about $540 million was for imported weapons. The domestic component of defense expenditures has probably at least doubled -- an increase of some $1 billion. Personnel expenditures have about tripled (from $220 million to nearly $700 million) as the force level rose to 300,000 men. Operating costs too will be much higher, and procurement from domestic defense production could reach about $750 million a year with these industries operating at full capacity, compared with $450 million last year.

Financing the War

Israel has moved rapidly to mobilize domestic and foreign resources to pay for the war. The government has issued bonds that all citizens and businesses must buy and is raising additional revenue through voluntary bond drives. These two sources are expected to bring in $500 million. The government also has ordered cuts in the development budget that will save $60 million.

If the cease-fire holds, the balance of payments should end the year in surplus because, with both imports and exports lower, the trade and services account should not change much, while there will be a large increase in contributions from abroad.

Exports of most goods and services have continued during the war, except those goods exported through the port of Eilat which remains blockaded. Agricultural exports have not been hurt; the important citrus crop is only now being harvested, and fresh produce has been exported by air. Exports of industrial products, except diamonds, slowed appreciably during the first week of the war, but have since recovered. Tourism, off an estimated 75%, is the only important source of earnings adversely affected to date. Demand for civilian imports has fallen off, but imports of military-related goods such as trucks and raw materials for defense industries are rising. The increased costs of war-risk insurance, which is being borne by the government, would add slightly to the import costs.

The pre-war Israeli projections of the balance of payments for 1973 anticipated receipt of $350 million in personal remittances and another $318 million in bond sales. Much of this probably was collected before the war. Since the war, the government has projected new goals of $1,250 million for personal remittances and $750 million for bond sales abroad through the end of 1974. If we assume that half of the new total will be collected by the end of 1973 and that other receipts remain as projected, the total of unilateral transfers and capital inflows for 1973 could be more than $2.0 billion.

Prospects for the Economy

Although the Israeli economy is unlikely to experience serious difficulties in the next few months, a number of uncertainties make it difficult to estimate the longer term impact of the war. In any case, the economy is unlikely to expand as rapidly as it did after the 1967 war, when there was much unused capacity and a clear victory greatly stimulated consumer demand and business expectation.

If the war ends with a definitive settlement and a favorable security environment, economic growth will resume and the long-term outlook will be favorable. The need for aid would depend on the amount and terms of arms purchases; aid for the civilian economy would be negligible. The proposed $2.2 billion US credit for Israeli military purchases would provide a military establishment considerably stronger than at the outset of the war, but perhaps not as strong as the Israelis now think they need. It could increase projected debt service payments of principal and interest by as much as $514 million a year on hard terms or $286 million on soft terms. The debt service to exports ratio at the estimated post-war export levels would be 50% with credit on hard terms, about the same as the average ratio during 1956-61.

If Israel is forced to maintain large forces in place for an uncertain cease-fire, military aid would be unchanged, domestic output would be reduced, new investment expenditure outside of armaments would be sharply curtailed, and personal consumption reduced somewhat. Foreign exchange needs

would be little affected, however, because demand for civilian imports would be held down as well. Israel would minimize the size of the armed forces by relying heavily on imported mechanized equipment rather than infantry.

Between these two extremes, many scenarios are suggested that would involve varying levels of mobilization and of costs to the economy. Included among these would be an extension of the Arab oil boycott that could possibly exert pressures on all EC countries to reduce their trade with Israel. Arab boycotts have not been effective in the past, although they lacked the leverage now afforded by oil. The Israelis, however, have always been resourceful in making adjustments in their foreign markets.

November 1973

S-6633

MEMORANDUM FOR: Mr. J. Thomas McAndrew
Chief, Near East Division
Office of Research and
Analysis for Near East and
South Asia, INR
Department of State

The attached information on economic dislocations in Israel is a follow-up to what [redacted] provided you by phone Thursday afternoon per your request.

25X1A

[redacted]

25X1A

Chief, Near East/Africa Branch
Developing Nations Division
Office of Economic Research
Central Intelligence Agency

22 November 1974
(DATE)

FORM NO. 101 REPLACES FORM 10-101
1 AUG 54 WHICH MAY BE USED. (47)

Distribution: (S-Project 6633)
Orig. & 1 - Addressee
1 - D/OER
1 - Acting Chief, D/D
~~1~~ - St/P/C
2 - D/NE

OER/D/NE:[redacted]:jlb/5741 (22 November 1974)

25X1A